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FINANCIAL DIGEST

MONDAY, JANUARY 14, 1980 VOLUME XVII, NUMBER 2

INCREASED DEFENSE SPENDING . . .

Unfolding developments in the Middle East have added a new element of confusion to an already clouded economic outlook. A growing number of economists are beginning to crank significant increases in defense spending into their models and are arriving at the conclusion that, whatever the current experience is called (slowdown, recession, stagflation), increased military outlays will soon change things dramatically. Needless to say, these forecasters also expect continued high rates of interest and inflation, leading to worse economic results longer term than the consensus now anticipates.

Such a view requires examination. It may be true that the Administration plans to boost military spending in response to developments in the Middle East. However, these outlays will not have their full impact on the economy until 1982 or later, since there are several steps in the process for military spending that must precede it. The first step is Congressional approval of obligational authority. At the moment, Defense Department gross obligations incurred are climbing—but no faster than the rate of inflation. The Administration undoubtedly will request authority to boost defense spending significantly in the budget that it will unveil in a few weeks. Needless to say, additional time will be required before the Congress approves any or all of these requests.

. . . WILL HAVE LITTLE NEAR-TERM EFFECT . . .

Once Congressional approval is obtained, the process enters into the next stage—appropriation of funds and awarding of contracts. Military prime contract awards for the Defense Department have declined, on balance, since early 1978, with a particularly steep decline noted in manufacturers' new orders for defense products. Clearly, it will be some time before these statistics turn around to reflect the current mood in Washington. Actual expenditures on defense-related items will take place only gradually, stretching out over years, in some cases, depending on the items purchased.

Reflecting the buildup in contract awards and orders that took place in 1976 and 1977, output of defense and space equipment, along with Defense Department net outlays for military functions and military assistance have recently begun to rise. Employment in defense products industries now totals over 1.3 million persons—the highest since 1970. However, the number of persons on active duty in the military, as well as civilians hired directly for employment in the Defense Department, are both plumbing 25-year lows.

. . . EXCEPT IN CERTAIN AREAS

Realistically, however, there may be some earlier impact even before the process of cranking up military expenditures gets underway. This is the anticipation effect by the private sector. If businessmen in those industries that normally participate in military programs believe that Washington is serious about the defense buildup, they will take steps relatively soon which may have some near-term effect. For example, they may hold on to—if not try to hire additional—skilled workers even though their current pace of operations would not justify such a policy. They might step up capital spending in anticipation of facilities that might be needed when and if military contracts are received. Areas of the United States that have heavy concentrations of defense contractors, like Long

(continued)

SELECTED FEDERAL RESERVE DATA

(Weekly Averages of Daily Figures – Millions of Dollars)

	Week Ending 1/9/80	Change Since Week Ago	Change Since Year Ago
Reserve Bank Credit:			
U.S. Gov'ts and Agencies Owned Outright & RPs	127,005	— 835	+14,376
Member Bank Borrowings	732	— 699	+ 46
Float	7,611	— 71	— 3,477
Total Reserve Bank Credit	140,976	—2,424	+12,062
Treasury Deposits with Federal Reserve Banks	2,812	— 795	— 304
Currency Outside Banks	113,485	— 549	+10,174
Member Bank Reserves:			
Required	44,568	+ 351	+ 2,724
Excess (Deficiency)	197	— 353	+ 319
Total Reserves Held	44,765	— 2	+ 3,043
Net Borrowed Reserves	474	— 343	— 241
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	80,715	— 248	—16,084
		r-Revised	
	1/2/80		
Money Supply ($ Bil., SA) M1	383.1	+ 0.1	+5.7%
Money Supply ($ Bil., SA) M2	954.1	-0-	+8.4%

NEW YORK MONEY MARKET

Offering Rates 1/11/80	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	11.61%	11.65%	10.73%
*Federal Agencies	12.70	12.60	11.58
*Project Notes—Tax Free (46% Taxable Equivalent)	N.A.	5.75	N.A.
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
*Secondary Market—Prime	13.25	13.25	

‡Finance Company Paper—Prime		‡*Bankers' Acceptances	
5- 14 days	10.00%	Feb.	13.00%
15- 29 days	10.00	Mar.	13.00
30- 59 days	13.00	Apr.	13.00
60- 89 days	12.75	May	12.90
90-179 days	11.75	June	12.65
180-270 days	11.00	July	12.55

‡Industrial Paper—Prime		
30- 89 days	12.75%	
90-120 days	12.00	

‡Federal Funds Effective Rate 14.13%

‡Discount Basis. *Subject to Availability. †Estimated.

SELECTED BUSINESS INDICATORS

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	3rd Q'79	$ 2,397	$ 2,330	$ 2,160
Gross National Product (1972 Dollars)*	3rd Q'79	$ 1,433	$ 1,422	$ 1,407
Percent Change, Annual Rate	3rd Q'79	3.1%	—2.3%	3.5%
Change in Consumer Prices (all urban consumers)*	Nov. '79	12.0%	12.0%	7.2%
Change in Producer Prices*	Dec. '79n	9.6%	15.6%	12.0%
Civilian Employment (Thousands of Persons)†	Dec. '79n	97,912	97,608	95,831
Unemployment as % of Civilian Labor Force†	Dec. '79n	5.9%	5.8%	5.9%
Personal Income*	Nov. '79	$ 1,999	$ 1,978	$ 1,801
Leading Indicators Composite Index (1967=100)†	Nov. '79	136.6	138.4	142.8
Industrial Production Index (1967=100)†	Nov. '79	151.6	152.4	150.6
Net Change in Consumer Instalment Credit†	Nov. '79n	$ 2.41	$ 2.19	$ 3.83
U.S. Merchandise Trade Balance†	Nov. '79	—$ 1.42	—$ 2.02	—$ 1.37
Plant and Equipment Expenditures*	1st Q'80	$189.32(a)	$184.32(a)	$165.94
Private Housing Starts (Thousands of Units)*	Nov. '79	1,518	1,762	2,107
New Construction Expenditures*	Nov. '79	$ 235.3	$ 238.5	$ 220.0
Total Business Inventories†	Oct. '79	$ 421.6	$ 417.3	$ 372.4
Total Business Sales†	Oct. '79	$ 299.0	$ 296.4	$ 266.7

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. a-Anticipated.

SHORT TERM PAPER OUTSTANDING

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Negotiable Time CDs Weekly Reporting Banks			
Nationwide (12/26/79)	92,372	— 600	— 4,621
New York City (1/9/80)	19,826	+ 250	
Commercial Paper (1/2/80)	112,972	+2,377	

BANK LOANS

(Millions of Dollars)

Weekly Reporting Large Commercial Banks	Commercial and Industrial Loans Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (12/26/79)	155,814	+1,131	+23,397
New York City (1/9/80)	47,536	— 481	

	Total Loans Gross Adjusted Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (12/26/79)	396,993	+3,735	+54,564
New York City (1/9/80)	89,887	—2,384	

SECURITY MARKETS

	Friday 1/11/80	Change Since Week Ago	Change Since Year Ago
U. S. Governments, Closing Bid Prices:			
90-Day Bills (Discount Basis)	11.80%	— .30	+ 2.45
180-Day Bills (Discount Basis)	11.74	— .23	+ 2.22
Longest Bills (Discount Basis)	10.82	— .30	+ 1.25
11⅜s 12/31/81	100.00	+ 7/32	
10½s 12/31/83	99.14	+ 4/32	
10¾s 11/15/89	100.14	— 6/32	
10½s 2/15/95	99.2	— 5/32	
10⅜s 11/15/09	100.3	— 7/32	
Municipals:			
Bond Buyer—20 Bond Index* (1/10/80)	7.30%	— .02	+ .80
Blue List Total ($ Million)	$ 863	—$ 158	—$ 12
30-Day Visible Supply ($ Million)	$1,546	+$ 424	+$ 895
Total	$2,409	+$ 266	+$ 883
Corporates:			
Moody's Aa Composite (1/10/80)	11.40%	+ .02	+ 1.90
Money Mgr.—30-Day Supply ($ Million)	$1,394	—$ 406	+$ 619
Stocks:			
Dow-Jones Averages			
Industrials	858.53	+ 29.69	+ 22.45
Transportation	257.01	+ 5.70	+ 39.34
Utilities	109.17	+ 2.23	+ 7.17
65 Stocks	304.94	+ 8.72	+ 2.14
Standard and Poor's 500 Stocks	109.92	+ 3.40	+ 9.99
N.Y.S.E. Composite Index	63.33	+ 2.16	+ 7.42
N.Y.S.E. Avg. Daily Vol. for Week (000's)	54,496	+13,988	+27,368

*46% Taxable Equivalent 13.52%

INTERNATIONAL RATES

	Friday 1/11/80	Week Ago
EURODOLLAR DEPOSIT RATES (bid)		
Overnight	14.00%	14.31%
1 month	14.00	14.44
3 months	14.13	14.56
6 months	14.13	14.44
1 year	12.88	13.13
EURODOLLAR BONDS Average Yield		
Medium Term (5 to 7 yrs.)	11.75%	11.65%
Long Term (10 to 15 yrs.)	11.80	11.75
FOREIGN EXCHANGE SPOT RATES New York Opening (in dollars)		
Belgium	.03577	.03584
Canada	.8585	.8552
France	.2480	.2487
Germany	.581[illegible]	.5832
Italy	.001243	.001245
Japan	.004237	.004207
Mexico	.04376	.04378
Netherlands	.5269	.5283
Switzerland	.6331	.6317
U.K.	2.2588	2.2353

Island, New York, the Route 128 periphery of Boston, Massachusetts, and parts of Southern California, should feel the effects of Washington's changed attitude toward defense spending pretty quickly. Obviously, the hiring of additional employees and construction of new facilities in anticipation of increased government defense outlays will give a boost to these local economies, stimulating activity from automobiles to real estate.

Other than this regional effect, there is not likely to be much change in the economy's near-term trend. There would have to be a military buildup on the scale of 1964-66 for there to be noticeable effects nationwide. It is generally acknowledged that the surge in defense spending associated with the Vietnam War prolonged the expansion of the 1960s, which otherwise might have come to an end around 1966-67. In any event, whatever the dimensions of the rise in military spending this time around, it cannot have much supportive effect this year because of the lags noted above.

PLUSES AND MINUSES ON INFLATION . . .

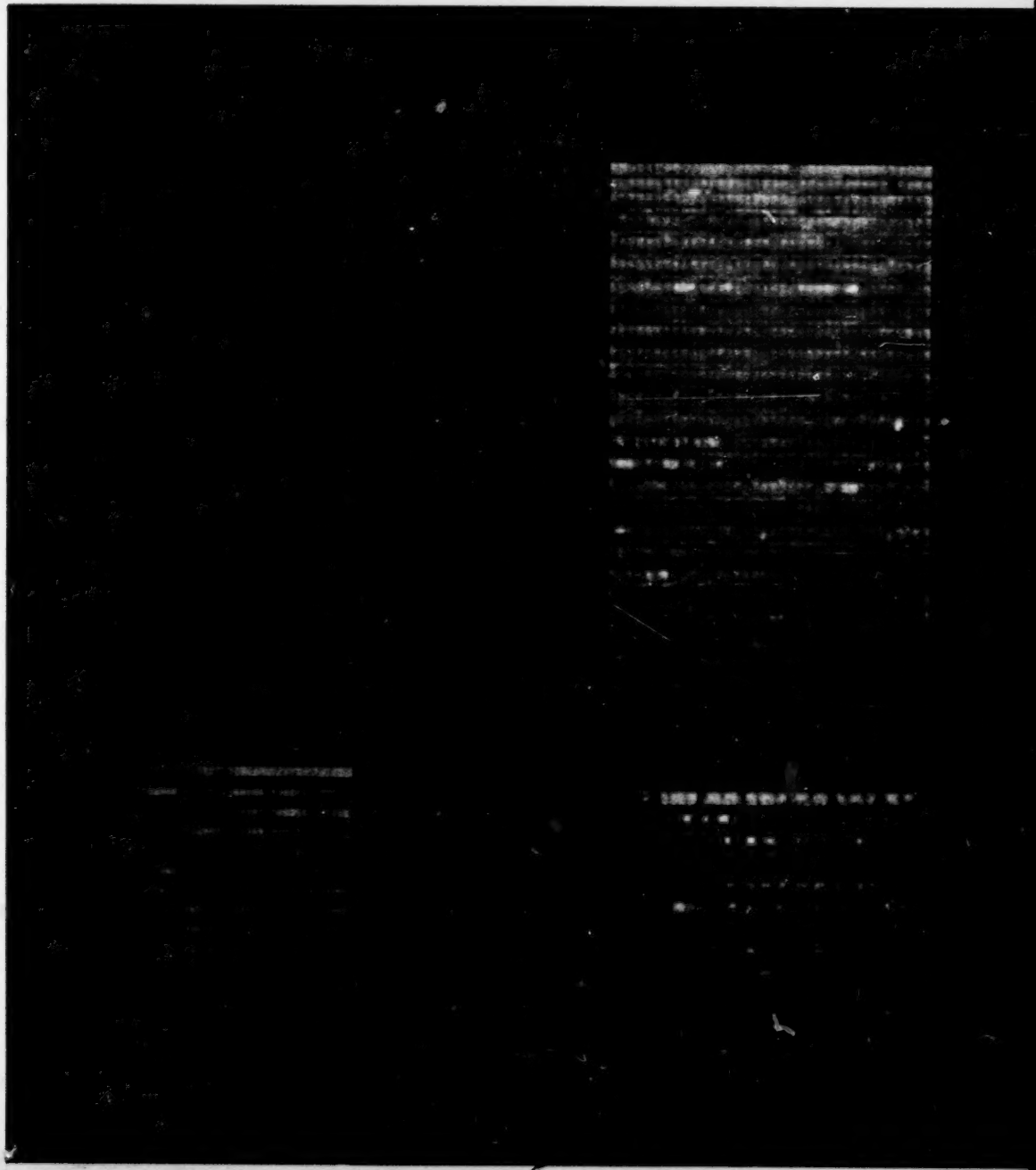
There is a possibility that the anticipation of greater defense outlays could affect interest rates and the rate of inflation well in advance of any actual rise in military spending. Certainly, this was the case in the Korean War, when sensitive commodities' prices shot up literally overnight, following the beginning of U.S. involvement in June, 1950. There was no such immediate reaction as the Vietnam War was escalated, however, suggesting that the Korean War situation was due more to memories of World War II scarcities than to any fundamental change in supply-demand relationships at that time. Of course, our method of financing the Vietnam War ("Guns and Butter") eventually caused the inflation rate to escalate to the point where we may well be feeling the aftershocks even to this date.

On the other hand, it should not be overlooked that rising military spending brings with it increased research and development outlays—not to mention greater growth of plant and equipment spending. Invariably, the channeling of more outlays into R & D produces new technologies which have non-military applications that can be used to develop more efficient methods of production in the private sector. The greater emphasis on plant and equipment spending also increases the economy's efficiency.

. . . BUT THE DEFICIT WILL REMAIN

Plainly, Washington's new attitudes on defense spending will have an impact on the budget for fiscal year 1981 that the Administration will unveil in a couple of weeks. Having already failed to fulfill his pledge to balance the budget in fiscal year 1980, it looks as though the President will be unable to achieve this goal even in fiscal 1981. Late last year, rumor had it that the President was going to propose a deficit for fiscal 1981 in the range of $12 billion to $15 billion. However, this was well before the Russian march into Afghanistan with its associated increased pressures for greater defense outlays. The deficit will be larger, if these pressures surface in the form of a surge in defense spending without any associated cut in nondefense outlays. And if Washington decides on a tax cut as well, a further swelling of the deficit is in prospect.

Such a development would jeopardize the Federal Reserve's policy of keeping money growth below an inflationary pace. If the Fed accomodates Washington's increased borrowing needs, more money and credit may be created than is consistent with noninflationary economic growth. On the other hand, if the Fed continues to slow money growth, Washington's increased borrowings would put pressures on the financial markets leading to a new rise in interest rates somewhere down the road.



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